Tilburg University

The future of banking – solving the current crisis while addressing long-term challenges

Beck, T.H.L.

Published in:
The Future of Banking

Publication date:
2011

Citation for published version (APA):
Beck, T. H. L. (2011). The future of banking – solving the current crisis while addressing long-term challenges. In T. H. L. Beck (Ed.), *The Future of Banking* (pp. 1-8). Centre for Economic Policy Research (CEPR).

VOX
Research-based policy analysis and commentary from leading economists

The Future of Banking – solving the current crisis while addressing long-term challenges

Thorsten Beck

25 October 2011

For better or worse, banking is back in the headlines. From the desperate efforts of crisis-struck Eurozone governments to the Occupy Wall Street movement currently spreading across the globe, the future of banking is hotly debated. This VoxEU.org eBook presents a collection of essays by leading European and American economists that discuss both immediate solutions to the on-going financial crisis and medium- to long-term regulatory reforms.

Three years after the Lehman Brothers failure sent shockwaves through financial markets, banks are yet again in the centre of the storm. While in 2008 financial institutions 'caused' the crisis and triggered widespread bailouts followed by fiscal stimulus programmes to limit the fall-out of the banking crisis for the rest of the economy, banks now seem to be more on the receiving end. The sovereign debt crisis in several southern European countries and potential large losses from a write-down of Greek debt make the solvency position of many European banks doubtful, which in turn explains the limited funding possibilities for many banks. As pointed by out many economists, including Charles Wyplosz in this collection of essays, policy mistakes have made a bad situation even worse.

The outrage about "yet another bank bail-out" is justified. The fact that banks are yet again in trouble shows that the previous crisis of 2008 has not been sufficiently used for fixing the underlying problems. If politicians join into the outcry, however, it is hypocritical, because it was them, after all, who did not use the last crisis sufficiently for the necessary reforms. After a short period in crisis-mode, there was too much momentum to go back to the old regime, with some minor changes here and there. This is not too say that I am advocating "radical" solutions such as nationalization. This is not exactly radical, as it has been tried extensively across the world and has failed. But wouldn’t it be actually radical to force financial institutions to internalize the external costs that their risk-taking decisions and their failure imposes on the rest of the economy? So rather than moving from ”privatizing profits and nationalizing losses” to nationalizing both, I would advocate to privatizing both (which might also reduce both profits and losses!). An old idea that has not really been popular among policy makers these past years in the industrialized world. An idea that some observers might call naive. But maybe an idea whose time has finally come.

A call for action

In the following, I will discuss in more depth the main messages of this book. But let me point to three headline messages:

1. We need a forceful and swift resolution of the Euro crisis, without further delay! For this to happen, the sovereign debt and banking crisis that are intertwined have to be addressed with separate policy tools. This concept finally seemed to have dawned on policy makers. Now it’s time to follow up on this insight and be resolute.
2. It’s all about incentives! We need to think beyond mechanical solutions that create cushions and buffers (exact percentage of capital requirements or net funding ratios) to incentives of financial institutions. How can regulations (capital, liquidity, tax, activity restrictions) be shaped that forces financial institutions to internalize all repercussions of their risk, especially the external costs of their potential failure?
3. It is the endgame, stupid. The interaction between banks and regulators/politicians is a multi-round game. As any game theorist will tell you, it is best to solve this from the end. A bail-out at failure will provide incentives for aggressive risk-taking throughout the life of a bank. Only a credible resolution regime that forces risk decision takers to bear the losses of these decisions is incentive compatible in aligning the interests of banks and the broader economy.

The Eurozone crisis – lots of ideas, little action

One of the important characteristics of the current crisis is that there are actually two crises ongoing in Europe – a sovereign debt and a bank crisis – though the two are deeply entangled. Current plans to use the EFSF to recapitalise banks, however, might not be enough, as there are insufficient resources under the plans. Voluntary haircuts will not be sufficient either; they rather constitute a bank bailout through the back door. Many policy options have been suggested over the past year to address the European financial crisis but, as time has passed, some of these are no longer feasible given the worsening situation. It is now critical that decisions are taken rapidly, the incurred losses are recognised and distributed clearly, and banks are either recapitalised where possible or resolved where necessary.

Comparisons have been made to the Argentine crisis of 2001 (Levy Yeyati, Martinez Peria, and Schmukler 2011), and lessons on the effect of sovereign default on the banking system can certainly be learned. The critical differences are obviously the much greater depth of the financial markets in Greece and across the Eurozone, and the much greater integration of Greece, which would turn a disorderly Greek default into a major global financial shock. Solving a triple crisis such as Greece's – sovereign debt, banking, and competitiveness – is more complicated in the case of a member of a currency union and, even though Greece constitutes only 2% of Eurozone GDP, the repercussions of the Greek crisis for the rest of the Eurozone and the global economy are enormous (similar to the repercussions of problems in the relatively small subprime mortgage segment in the US for global finance in 2007-8).

One often-discussed policy option to address the sovereign debt crisis is creating euro bonds, i.e. joint liability of Eurozone governments for jointly issued bonds. In addition to their limited desirability, given the moral hazard risk they are raising, their political feasibility in the current environment is doubtful. Several economists have therefore suggested alternatives, which would imply repackaging existing debt securities into a debt mutual fund structure (Beck, Uhlig and Wagner 2011), or issuing ESBies funded by currently outstanding government debt up to 60% of GDP, a plan detailed by Markus Brunnermeier and co-authors in this book. By creating a large pool of safe assets – about half the size of US Treasuries – this proposal would help with both liquidity and solvency problems of the European banking system and, most critically, help to distinguish between the two. Obviously, this is only one step in many, but it could help to separate the sovereign debt crisis from the banking crisis and would allow the ECB to disentangle more clearly liquidity support for the banks from propping up insolvent governments in the European periphery.

Regulatory reform – good start, but only half-way there

After the onset of the global financial crisis, there was a lot of talk about not wasting the crisis, but rather using it to push through the necessary regulatory reforms. And there have been reforms, most prominently the Dodd-Frank Act in the US. Other countries are still discussing different options, such as the recommendations of the Vickers report in the UK. Basel III, with new capital and liquidity requirements, is set to replace Basel II, though with long transition periods. Economists have been following this reform process and many have concluded that, while important steps have been taken, many reforms are only going half-way or do not take into account sufficiently the interaction of different regulatory levers.

The crisis has shed significant doubts on the inflation paradigm – the dominant paradigm for monetary policy prior to the crisis – as it does not take into account financial stability challenges. Research summarised by Steven Ongena and José-Luis Peydró clearly shows the important effect that monetary policy, working through short-term interest rates, has on banks' risk-taking and, ultimately, bank fragility. Additional policy levers, such as counter-cyclical capital requirements, are therefore needed.

The 2008 crisis has often been called the grave of market discipline, as one large financial institution after another was bailed out and the repercussions of the one major exception – Lehman Brothers' bankruptcy – ensured that policymakers won't use that instrument any time soon. But can we really rely on market discipline for systemic discipline? As Arnoud Boot points out, from a macro-prudential view (i.e. a system-wide view) market discipline is not effective. While it can work for idiosyncratic risk choices of an individual financial institution, herding effects driven by momentum in financial markets make market discipline ineffective for the overall system.

Ring fencing – the separation of banks' commercial and trading activities, known as the Volcker Rule but also recommended by the Vickers Commission – continues to be heavily discussed. While Boot thinks that "heavy-handed intervention in the structure of the banking industry … is an inevitable part of the restructuring of the industry", Viral Acharya insists that it is not a panacea. Banks might still undertake risky activities within the ring. Capital requirements might be more important, but more important still than the actual level of such requirements is the question of whether the current risk weights are correct. For example, risk weights for sovereign debt have certainly been too low, as we can see in the current crisis in Europe. Critically, we need to fundamentally rethink the usefulness of static risk weights, which do not change when the market's risk assessment of an asset class permanently changes. In addition, capital requirements have to take into account the co-dependence of financial institutions, as pointed out by Acharya and Matthew Richardson. This would lead to systemic risk surcharges, though they might not necessarily be perfectly correlated with the size of financial institutions. And whatever is being decided for the banking sector should trigger comparable regulation for the shadow banking sector to avoid simply shifting risk outside the regulatory perimeter.

Tweaking different levers of the regulatory framework independent of each other can, however, create more risk instead of mitigating it. Capital requirements and activity restrictions that do not take into account the governance and ownership structure of banks can easily have counterproductive effects, as Luc Laeven argues. Stricter capital regulations can actually result in greater risk-taking when the bank has a sufficiently powerful and diversified owner, but have the opposite effect in widely held banks. A one-size-fits-all approach is therefore not appropriate.

Another area of reform has been liquidity requirements, recognised as the biggest gap in Basel II. Enrico Perotti, however, points out that the suggested reforms – liquidity coverage ratios (buffers of liquid assets as a fraction of less stable funding) and net funding ratios **(**quantitative limits to short-term funding) – are (a) too rigid, (b) procyclical, and (c) distortionary against efficient lenders. He rather recommends using those ratios as longterm targets while imposing 'prudential risk surcharges' on deviations from the targets.

Taxation of banks – why settle for fourth-best?

For many years, taxation of financial institutions was a topic for specialists, as much among tax or public finance economists as among financial economists. The current crisis and the need for large recapitalisation amounts for banks have changed this dramatically, and taxation for banks now forms part of a broader debate on regulatory reform. Proposals to introduce a financial transaction tax, in one form or another, have emerged in the political arena over the past three years with a regularity that matches seasonal changes in Europe. As Harry Huizinga and I point out, such a tax would not significantly affect banks' risk-taking behaviour. Rather, it might actually increase market volatility and its revenue potential might be overestimated. Banks are under-taxed, but there are better ways to address this gap, such as eliminating the VAT exemption on financial services or a common EU framework for bank levies.

Looking beyond national borders

Cross-border banking in Europe can only survive with a move of regulation and resolution of cross-border banks to the European level, as emphasised by Dirk Schoenmaker. If the common market in banking is to be saved, the geographic perimeter of banks has to be matched with a similar geographic perimeter in regulation, which ultimately requires new European-level institutions. Many of the reforms being discussed or already implemented, including macro-prudential tools and bank resolution, have to be at least coordinated if not implemented at the European level (Allen et al. 2011). Critically, the resolution of financial institutions has an important cross-border element to it. In 2008, authorities had limited choices when it came to intervening and resolving failing banks and, in the case of cross-border banks, resolution had to be nationalised. Progress has been made in the reform of bank resolution, both in the context of the Dodd-Frank Act and in the preparation of living wills. More remains to be done, especially on the cross-border level.

While most of the discussion is currently on banking system reform in the US and Europe, we should not ignore trends in the emerging world. As Neeltje van Horen points out in her contribution, among the global top 25 banks (as measured by market capitalisation), there are 8 emerging-market banks, including 4 Chinese, 3 Brazilian, and 1 Russian. Due to their sheer size, emerging-market banks will almost undoubtedly soon become important players in the world's financial system. And given that US and European banks are still to adjust to the new rules of the game, large banks from the emerging countries are likely to step into the void left by advanced-country banks. There will be a continuing shift towards emerging markets also in banking!

Why do we care?

Above all, however, it is important to remind ourselves of why we care about the banking sector in the first place. Given the roles of credit default swaps, collateralised debt obligations, and other new financial instruments in the recent financial crisis, financial innovation has garnered a bad reputation. But in his contribution, Ross Levine reminds us of the powerful role of financial innovation through history in enabling economic growth and the introduction of new products and providers in the real economy. Financial innovation fosters financial deepening and broadening. Rather than stifling it, we have to harness it for the benefit of the real economy.

References

Allen, Franklin, Thorsten Beck, Elena Carletti, Philip Lane, Dirk Schoenmaker and Wolf Wagner (2011), *Cross-border banking in Europe: implications for financial stability and macroeconomic policies*. CEPR.

Beck, Thorsten, Harald Uhlig and Wolf Wagner (2011), "Insulating the financial sector from the European debt crisis: Eurobonds without public guarantee"., VoxEU.org.

Levy Yeyati, Eduardo, Maria Soledad Martinez Peria and Sergio Schmukler (2011), "Triplet Crises and the Ghost of the New Drachma", VoxEU.org.

Topics: EU institutions, EU policies, Europe's nations and regions, Financial markets, Macroeconomic policy, Politics and economics, Taxation

Tags:

Comments